

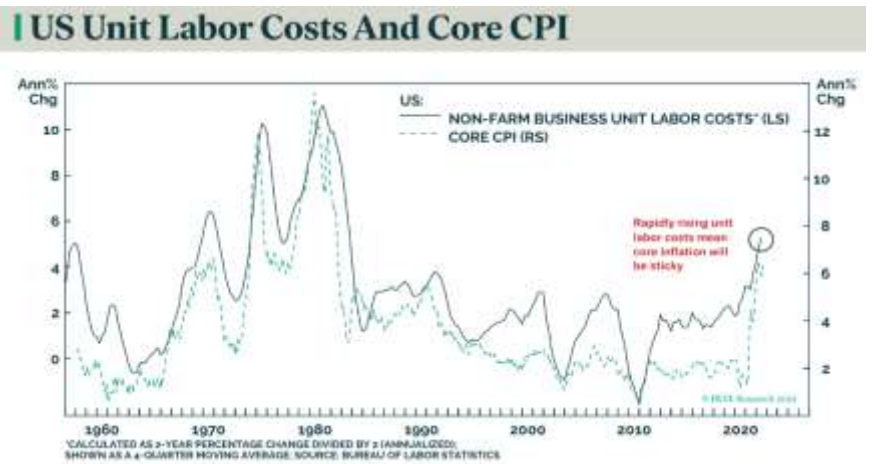
**Economic and Market Environment**

2022 will be remembered as the year where low inflation and ‘free money’ came to an abrupt end in the Western World. Since the early eighties, inflation in Europe and the United States had been on a structural downward trend, so much so that most investors, companies and households had never experienced real inflation. As we can see on the graph below, US inflation (in yellow) and EU inflation (in white) hovered around 1 to 2% for most of the past three decades with some short-lived peaks at 4%. Everything changed this year though, when inflation shot up to over 9% and even reached double digits in some European countries.



Figure 1 - US inflation (in yellow) and Eurozone inflation (in white) (source: Bloomberg)

Central bankers, politicians and a number of economic commentators initially thought it was just a temporary adjustment resulting from the end of the COVID-19 pandemic, but the length of this inflation wave partially fuelled by the Russian-Ukraine war makes us think that we are unlikely to go back to the pre-pandemic economic and financial environment. There is a chance that the inflation rate will go down next year as energy prices are unlikely to rise much more from their current elevated levels, but we think it is unlikely that it will go back to 2% in the short term. We are now seeing more and more wage pressure driven by tight labour markets, unionization and inflation linked wages (as in Belgium). More than ever, it will be important for savers to invest in real assets to keep their purchasing power intact and hopefully generate some modest real returns. Sitting



too long on the side-lines could quickly prove costly as inflation compounds and could quickly erode savings. Over five years, cash loses 22% of its purchasing power in a 5% annual inflation rate environment and 41% of its purchasing power when inflation runs at 10% annually.

Unfortunately, inflation also tends to distort the economy and makes it difficult for managers and politicians to properly run businesses and governments. It also creates volatility in financial markets as we have seen this year. In a declining inflation and interest rate environment, investors can buy nearly any asset (real estate, private equity, stocks, bonds...) and make money. When inflation and interest rates go the other direction, investors need to be very careful and avoid financial instruments where losses can be significant and unrecoverable.

For those who have followed us in recent years, you will know that we have been negative on bonds for a while and find it damaging that bonds are sometimes represented as 'safe' investments for 'conservative' investors. As we can see on the graph below, European government bonds retreated ~15% this year, the worst performance since this Bloomberg index started in 2000. While some managers claim the worst is behind us and it is now time to start buying bonds back, we remain cautious as real yields (bond yield – inflation rate) are still significantly negative and we could still see further rate hikes. We are not the only ones in this camp. Blackrock, the world's largest asset manager<sup>1</sup> is now shunning sovereign bonds in all its investment scenarios.

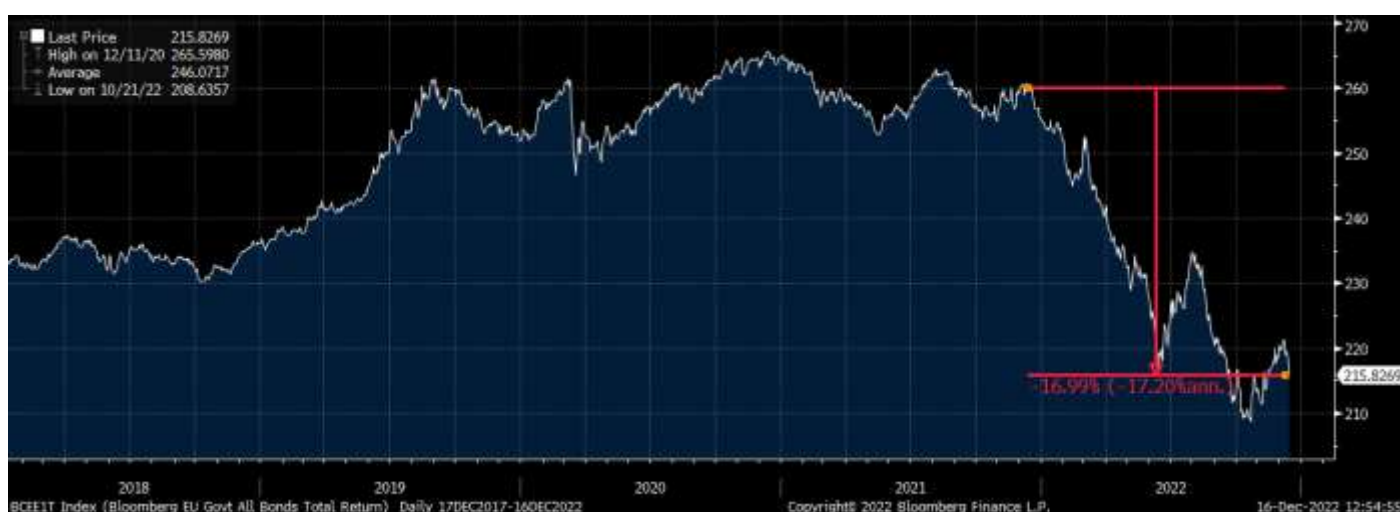


Figure 2 – European Government Bond index (source: Bloomberg)

Overall, the world economy is also in a relatively fragile situation<sup>2</sup> with Europe deeply mired in a cost-of-living/energy crisis, China suffering from a real estate crisis, complicated by COVID management and the United States from seing high inflation. In this trio, the American economy appears to be in the best shape as most of the issues are due to economic overheating, which hopefully will be solved by some cyclical adjustments. American inflation is mostly internally driven with wages growing faster than productivity, whilst European inflation is due to the energy price choc caused by the Ukraine war. This means that American workers earn a lot more in nominal terms, and a lot of wages are growing faster than inflation, whilst European workers are unfortunately structurally poorer due to an external economic shock. The economic research house BCA recently estimated that *“The European economy is facing stronger near-term headwinds than the US economy. Both the German manufacturing and services sectors are set to slow further in the coming few months, beset by a massive decline in European real wages (-6.2% compared with -2.5% in the US)”*. The difficult European situation reminds us why at TreeTop, we take a global approach to investing as generally we can always find an area of the world or asset class with interesting prospects.

In Asia, the Chinese economy looks is behaving in complete contrast to the American economy, with the Chinese central bank loosening liquidity and cutting interest rates as they are facing a real estate slump, high youth unemployment and near deflation. The country continues to be extremely efficient at producing low cost and high

<sup>1</sup> <https://www.bloomberg.com/news/articles/2022-12-13/blackrock-s-top-bet-is-shunning-sovereign-bonds-in-all-scenarios?leadSource=verify%20wall>

<sup>2</sup> <https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022>

quality goods, but local demand has slowed down a lot. China experienced a record trade surplus of over USD600bn in 2021<sup>3</sup> and it appears that the surplus in 2022 will be close to that level too.

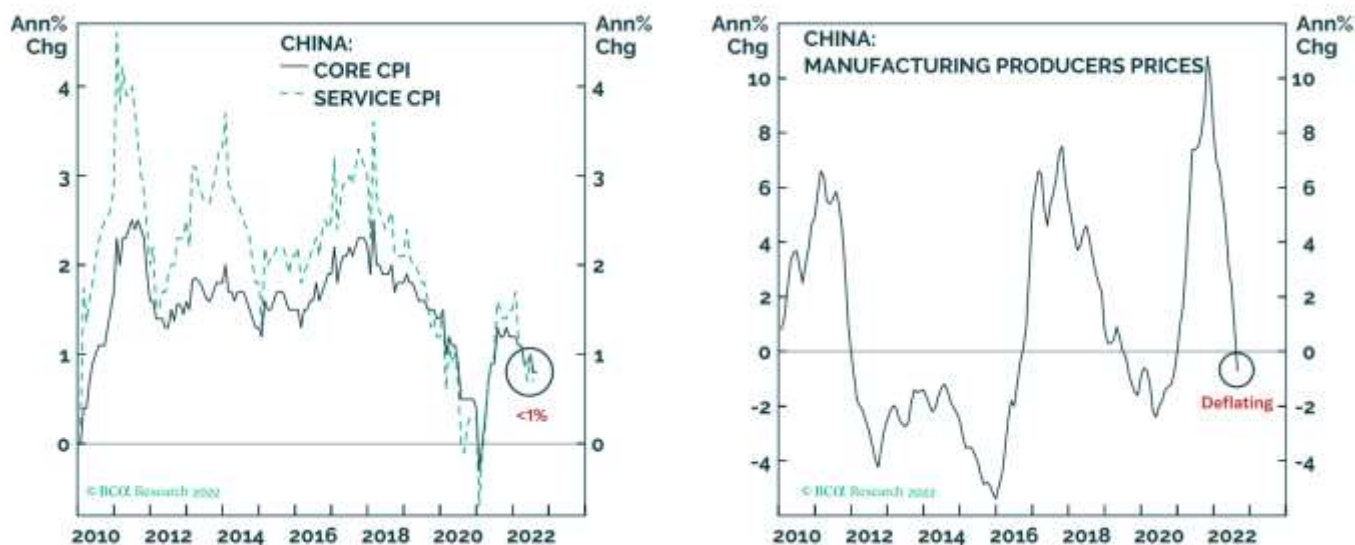


Figure 3 – Consumer Prices Index (CPI) and Manufacturing Producers Prices evolution in China (source: BCA Research)

The breakneck consumption growth in the country is likely behind us though as wage growth has slowed down a lot<sup>4</sup>. In general, China will need to find new growth drivers as the wave of urbanization is mostly behind us. Most Chinese households now have a modern flat (if not several), a car and modern jobs. The next phase of growth will require creative innovation that could prove challenging in a political environment which likes control and uses censorship aggressively. China has been a fantastic development story over the last three decades and its society has always been able to meet new challenges so we will continue to look for opportunities keeping the economic, social & political challenges in mind. South Asia (India and some South-East Asian countries) by contrast continues to go from strength to strength. The World Bank recently upgraded its forecasts for the Indian economy<sup>5</sup> citing good macro-economic policies and structural reforms. India is now the fifth largest economy in the world (3<sup>rd</sup> using the PPP methodology) and the home for world leaders in petrochemicals, telecommunication, technology and pharmaceuticals. In South-East Asia, the Philippines<sup>6</sup>, Indonesia<sup>7</sup> and Vietnam<sup>8</sup> continue to do very well and have good economic prospects with large and young populations, improving institutions like independent central banks and courts and a dynamic business culture. Over the next decade, South Asia will also benefit from a demographic dividend whilst the rest of the world is ageing. The median age in India is only 28 compared to 38 in China and the US and over 47 in Japan & Germany.

Overall, investors in 2023 should remember that we are seeing a very different financial & economic environment than the one we lived through in recent years. **Global equity markets** and **public markets** in general due to their liquidity quickly adjusted to this new environment. However, real estate, private debt instruments, private equity (venture capital, LBO...) trade much more sparingly and tend to take more time to adjust. Our contact with investors in private and public equity told us informally that public equity trades at a 30 to 50% discount to the private deals they are seeing, hence they avoid most private equity deals in this environment. Another indicator is the publicly listed stocks of private equity giants like Partners Group, Blackstone and KKR which are all down around 40% or more for the year.

<sup>3</sup> <https://tradingeconomics.com/china/balance-of-trade#:~:text=Balance%20of%20Trade%20in%20China,Billion%20in%20February%20of%202020>

<sup>4</sup> <https://www.bloomberg.com/news/articles/2022-10-25/china-urban-wages-grew-just-2-2-so-far-this-year-on-covid-curbs?leadSource=uverify%20wall>

<sup>5</sup> <https://www.worldbank.org/en/news/press-release/2022/12/05/india-better-positioned-to-navigate-global-headwinds-than-other-major-emerging-economies-new-world-bank-report>

<sup>6</sup> <https://www.adb.org/news/adb-forecasts-7-4-growth-philippines-2022#:~:text=The%20latest%20supplement%20to%20the,the%20previous%20forecast%20of%206.3%25>

<sup>7</sup> <https://www.adb.org/news/indonesia-economy-holding-well-2022-faces-headwinds-2023-ADB>

<sup>8</sup> <https://www.worldbank.org/en/news/press-release/2022/08/08/vietnam-s-economy-forecast-to-grow-7-5-in-2022-new-world-bank-report-says>



Figure 4 – Stock price performance of major listed private equity companies (source: Bloomberg)

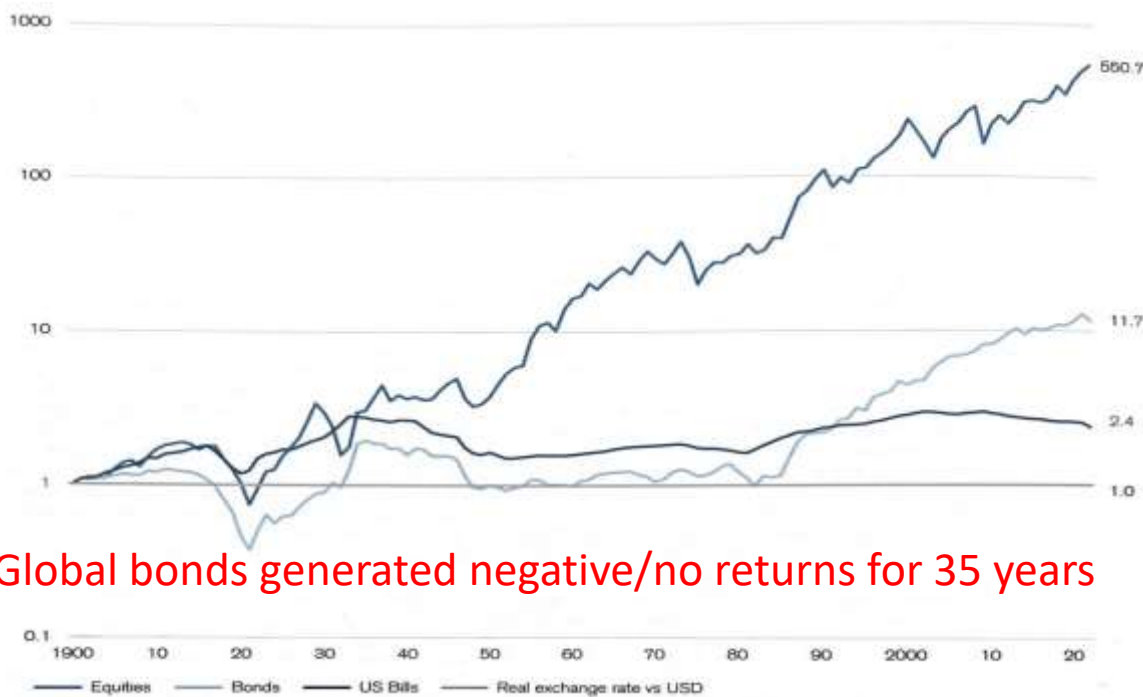
Real estate is not necessarily much better, as rising interest rate yields will increase the cost of debt and rental yields will need to go up to compensate for the higher cost of money. The energy crisis in Europe will also create pressure on landlords to renovate buildings, which will add additional costs. While nominal returns (before inflation) over long periods are likely to be fine in high quality real estate<sup>9</sup>, the road could be bumpy and more than ever a good selection of goods will be crucial. In the US for example, an average monthly mortgage of USD2,500 could have afforded you a house of USD758,572 at the beginning of the year but only USD476,425 today!



Figure 5 – How much home can you buy with a \$2,500 monthly mortgage payment, assuming a 20% down payment & average 30Y mortgage rate (source: Bloomberg)

While as you all know, past returns will not necessarily replicate in the future, it is still interesting to know that an investor who bought the global stock market in 1900 made 550x his money but only 11.7x his investment when they bought bonds. As we all have a limited time on earth, the more important lesson is that there are long periods - 35 years plus as shown on the graph below - where investors would not have made money in global bonds but the stock market has always generated good returns in the past over these long periods.

<sup>9</sup> No guarantee of results or performance



## Global bonds generated negative/no returns for 35 years

Figure 6 - Source: Credit Suisse Global Investment Returns Yearbook 2022 Elroy Dimson, Paul Marsh, and Mike Staunton, DMS Database 2022, Morningstar.

For illustrative purpose only. Past market behaviours do not prejudge future behaviours.

At TreeTop and with the help of our colleagues at Aubrey Capital Management Ltd<sup>10</sup> (hereafter “Aubrey Capital”), we will continue to look for the best public equity opportunities, wherever they are. As volatility is the unfortunate by-product of the good long-term returns of global equity, it is always good to recall the wise words of Rudyard Kipling:

*“If you can keep your head when all around you are losing theirs, If you can wait and not be tired by waiting, If you can think and not make thoughts your aim, If you can trust yourself when all men doubt you, Yours is the Earth and everything that’s in it.”*

We wish a happy and hopefully financially rewarding 2023 and remain available for any potential questions.

## Our convictions

Our strategy in 2022, while still down for the year, performed better than most major world indexes as a result of a few good decisions in 2021. Seeing the significant increase in valuation of growth companies across the world, we decided at TreeTop to (1) launch a new RDT<sup>11</sup> product purely focused on American listed value names, (2) re-allocate part of our strategy to the **DOGS of the DOW** and keep a large weighting in some deep value names like **FUFENG**, (3) increase the weight of value strategies in our patrimonial products. We are happy to say that these were generally the right decisions, though in hindsight some of our changes could have been more aggressive.

As far as our strategy is concerned, our biggest performance contributor was **FUFENG**, a leading amino-acid and food additive producer from China. We have followed the Company for ten years now and progressively built a large position. Our thesis is simple, the Company - thanks to its investments in factories and production technology - had become the cost leader in its industry, with its Chinese listed peer Meihua. Benefitting from a low-cost base, the Company progressively consolidated the industry undercutting its rivals and expanding into the production of other amino acids. For a few years, our investment in **FUFENG** hadn’t been financially rewarding as **FUFENG**’s profit was volatile and not growing very much due to constant price wars. Like for the market in general, patience in single stock

<sup>10</sup> Aubrey Capital Management Ltd is a specialist global manager with a distinctive investment approach located in Edinburgh and London, and which works closely with TreeTop Asset Management S.A.

<sup>11</sup> RDT for “Revenus Définitivement Taxés” in French, translated as “definitively taxed income”

investing is generally a virtue and a good investment is not always straightforward. Nevertheless after a few disappointing years, the amino industry in China reached a turning point and both **FUFENG**'s and Meihua's management raised prices and improved the profitability of their Companies significantly. This led to outstanding stock performance in a very difficult market. We continue to keep a large position as the stock still trades on a low single digit price to earnings multiple and a mid-teens dividend yield.

Over the last two months, we also decided to divest several of our medium sized companies in Asia and replace them with **Dow Jones Global Titans**. The rationale of this transaction is that the general economic backdrop, and particularly the economic prospects in China are quite challenging. In addition, our clients already have a lot of exposure to large American tech companies through our global index and to growth companies all over the world through the different investment strategies of Aubrey Capital included in TreeTop funds' strategies. To provide more diversification and hopefully less volatility but good returns, we decided to allocate a portion of our strategy to these large 'value' listed companies. We select the stocks with the highest dividend yields, as well as the ones which generate at least 30% of their revenue outside the United States. As a result, our equity strategy is now largely exposed to large market capitalisations with good dividend yields. The rationale behind this decision is that over time, the 'value' part (lower valuation multiples but lower growth) of major indexes like the S&P500 provide the same returns as the 'growth' part, but tend to be a little less volatile and more importantly, tend to perform well when the 'growth' part of the index performs badly. The table below shows that since 1999, the two components of the S&P500 - value and growth - only had a 2% difference in performance, the only major difference being that the majority of returns came from price appreciation for the growth index and from dividends for the 'value' index.



Figure 7 – S&P500 'value' and 'growth' indices since 1999 (Source: Bloomberg)

As a result of these changes, our largest investments in our equity strategy are now mostly American listed companies with good dividend yields and low valuation multiples<sup>9</sup>. In the table below, you will find the description of these large investments as well as their dividend and price to earnings multiple.

Company		2022		Company Description
Tickers	Name	PE	Dividend Y	
546 HK	Fufeng Group Ltd	3.3	11.3	Fufeng Group Limited manufactures corn-based bio-chemical products utilizing fermentation technology. The Company's products include glutamic acid and xanthan gum.
CSCO US	Cisco Systems Inc	13.2	3.3	Cisco Systems, Inc provides information technology and networking services. The Company offers enterprise network security, software development, data collaboration, cloud computing, and other related services. Cisco Systems serves customers in the United States.
VZ US	Verizon Communications Inc	7.3	6.9	Verizon Communications Inc. operates as a telecommunications company. The Company provides wire line voice, data services, wireless and internet services. Verizon Communications serves clients in the United States.

Company		2022		Company Description
Tickers	Name	PE	Dividend Y	
KO US	Coca Cola Co / The	25.4	2.8	The Coca-Cola Company manufactures, markets and distributes soft drink concentrates and syrups. The Company also distributes and markets juice and juice-drink products. Coca-Cola distributes its products to retailers and wholesalers worldwide.
JPM US	JPMorgan Chase & Co	11.7	3.0	JPMorgan Chase & Co. provides global financial services and retail banking. The Company provides services such as investment banking, treasury and securities services, asset management, private banking, card member services, commercial banking and home finance. JPMorgan Chase serves business enterprises, institutions and individuals.
DOW US	Dow Inc	7.7	5.7	Dow Inc produces and distributes chemical products. The Company manufactures and supplies chemicals for liquid injection molding, architecture fabrication, leather textiles, automobiles, rubber consumer goods and food industries. Dow serves customers worldwide.
IBM US	International Business Machines	15.5	4.8	International Business Machines Corporation (IBM) provides computer solutions. The Company offers application, technology consulting and support, process design and operations, cloud, digital workplace and network services, as well as business resiliency, strategy and design solutions. IBM serves clients worldwide.
MMM US	3M Co	11.8	5.0	3M Company conducts operations in electronics, telecommunications, industrial consumer and office, health care, safety and other markets. The Company businesses share technologies, manufacturing operations, marketing channels and other resources. 3M serves customers worldwide.
CVX US	Chevron Corp	8.9	3.3	Chevron Corporation operates as a renewable fuel company. The Company produces and transports crude oil and natural gas, as well as refines, markets and distributes fuels. Chevron serves clients worldwide.
WBA US	Walgreens Boots Alliance Inc	8.5	5.2	Walgreens Boots Alliance, Inc., operates retails drugstores. The Company offers a wide variety of prescription and non-prescription drugs, as well as primary and acute care, wellness, pharmacy and disease management services, and health and fitness. Walgreens Boots Alliance serves customers in the United States.

Source: TreeTop Asset Management S.A.

In conclusion, 2022 has been a tumultuous year in financial markets and will mark a significant change in the economic and financial environment across the world. Changing times require adaptability and we will continue to work hard at TreeTop to adjust our offering to these changes. Hopefully changes will be financially rewarding. Please feel free to contact us if you have any questions on our strategy or the market in general.

***My son Felix has been writing the newsletter with me for several years now and we are now belatedly recognizing his work as a co-author.***

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*Data & Information as of 31<sup>st</sup> December 2022*

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